Your Road Map to Leveraging 2021's SEC Risk Alerts to Prepare for 2022

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As the industry awaits the U.S. Securities and Exchange Commission's ("SEC") annual examination priorities in the first quarter of 2022, firms contemplate the transformations and evolution of their business strategies for 2022 – often asking "What's different?" and "What needs to change?".

Throughout the year the SEC's Division of Examinations ("EXAMS") provided ample guidance and insight to specific areas of focus through issued *Risk Alerts*.

Risk Alerts provide tremendous insight into the most common examination deficiencies found in a particular area, as well as best practices observed from the SEC staff during its recent examinations. Notably, the highlighted deficiencies within the *Risk Alerts* have become prominent pain points for firms throughout the examination process.

Risk Alerts often serve as a call to action for firms to address and strengthen their policies and procedures. *Risk Alerts* also provide timely and relevant information as a way of helping firms mitigate their regulatory, operational, and regulatory risks and advance their compliance efforts. Moreover, they can help your firm prepare for its next SEC examination.

In this article, we will explore three prominent *Risk Alerts* of 2021 relating to advisory fees, wrap fee programs, and the robust growth of Environmental, Social, and Corporate Governance (ESG) investing.

Advisory Fees

EXAMS recently concluded a national initiative that focused on advisory fees, predominantly those charged to retail clients. The initiative assessed the various ways investment advisers charge fees for their services, the adequacy of fee disclosures, the accuracy of fee calculations, and the effectiveness of the examined advisers' compliance programs and accuracy of their books and records.

Notable deficient practices the SEC has observed:

- **Inaccurate percentages were used to calculate advisory fees.** The SEC staff identified examined advisers that, among other things, charged fees that were different from contractually agreed-upon rates and failed to convert all clients to their new or updated fee schedule.

- **Advisory fees were double billed.** Such errors were typically due to oversights, such as not updating a system following a change in billing practices.

- Breakpoint or tiered billing rates were not correctly calculated. Often these issues related to tiered fee schedules not being applied correctly or applied at all.

- **Householding of client accounts were not correctly calculated**. Examined advisers did not aggregate client or family accounts and/or apply the declining fee schedule.

- **Inconsistently refunding unearned fees.** The examined advisers were obligated to refund unearned advisory fees but were inconsistent in providing refunds to clients.

- **Requiring clients to provide written requests to refund unearned advisory fees.** In these instances, the examined advisers had policies to refund prepaid advisory fees only upon five (5) written notices from clients.

- **Several of the examined advisers were identified as having a range of disclosure issues.** Common deficiencies observed included incomplete or misleading Form ADV Part 2 brochures and/or other disclosures, a lack of any written agreements or documentation establishing the client fee amount, and inaccurate disclosures regarding the timing of their fee billing.

- **Insufficient policies and procedures that specifically address fee calculations and material advisory fee components.** The staff identified policies and procedures that were generic in nature and did not address specifics related to the processes for computing, billing, and testing advisory fees.

Three (3) steps advisers should take to address Advisory Fees in 2022:

1. **Adopt and implement written policies and procedures addressing advisory fee billing processes and validating fee calculations.** The SEC generally observed fewer errors when the examined advisers had specific written policies and procedures addressing the supervision, calculation, review, and billing of advisory fees.

2. **Centralize the fee billing process and validate that the fees charged to clients are consistent with compliance procedures, advisory contracts, and disclosures.** The staff observed that the examined advisers with centralized billing – rather than billing that was dispersed throughout the adviser with separate, supervised persons preparing and invoicing client billing statements – had fewer clients being billed incorrectly or client accounts being calculated inconsistently with the advisers' written policies and procedures.

3. **Ensure resources and tools established for reviewing fee calculations are utilized.** The staff observed that checklists and other resources for reconciling client fee calculations with client advisory agreements may be useful tools when used consistently by all advisory personnel.

Managing Client Accounts in Wrap Fee Programs

EXAMS has recently intensified its focus on wrap fee programs because of the continued growth of investor assets participating in such programs, as well as the conflicts and disclosure practices observed during previous examinations.

Notable deficient practices the SEC has observed:

- **Recommendations were made that were inconsistent with responsible fiduciary duty or not made in clients' best interests.** Several issues were found related to both the advisers' trading practices and their assessments that the wrap fee programs were initially, and on an ongoing basis, in the best interests of their clients.

- **Advisers had omitted or provided inadequate disclosures, particularly regarding conflicts of interest, fees, and expenses.** Advisers often had inconsistent disclosures regarding the same topic in various documents and/or omitted disclosures or inadequately described conflicts of interest.

- **Weak or ineffective compliance policies and procedures relating to advisers' wrap fee programs**. Advisers inconsistently implemented or enforced, or failed to implement, their policies and procedures and did not perform required annual reviews or performed the reviews inadequately.

Three (3) steps advisers should take to address Wrap Fee Programs in 2022:

1. **Conduct reviews of wrap fee programs to assess whether the recommended programs are in the best interests of clients.** This can be done by using information obtained directly from clients through interviews, discussions, and/or questionnaires.

2. **Periodically remind clients, after conducting initial best interest reviews associated with the recommendation to participate in wrap fee programs, to report any changes to their personal situations such as their investment objectives or risk tolerance.** Advisers should send clients reminders orally and in writing and establish a fixed schedule of communication.

3. **Provide clients with disclosures regarding conflicts of interest related to transactions executed within the wrap fee programs.** Disclose whether clients may incur more costs by participating in a wrap fee program than if they received similar services provided in other types of accounts and whether compensation or incentives are received from wrap fee program sponsors.

Risk Areas Related to ESG Investing

In response to investor demands, advisers have expanded their various approaches to ESG investing and increased the number of product offerings across multiple asset classes. EXAMS has found a lack of standard and precise ESG definitions, as well as instances of potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks.

Notable deficient practices the SEC has observed:

- **Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.** The staff noted weaknesses in policies and procedures governing implementation and monitoring of the advisers' clients' or funds' ESG-related directives.

- **Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices.** Inconsistencies were found between actual firm practices and ESG- related disclosures and marketing materials because of a weakness in controls over public disclosures and client/investor-facing statements.

- **Compliance programs did not adequately address relevant ESG issues.** Some firms substantially engaged in ESG investing lacked policies and procedures addressing their ESG investing analyses, decision-making processes, or compliance review and oversight.

- **Proxy voting may have been inconsistent with advisers' stated approaches.** Inconsistencies were found between public ESG-related proxy voting claims and internal proxy voting policies and practices.

- **Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches.** The staff observed unsubstantiated or otherwise potentially misleading claims regarding ESG investing in a variety of contexts.

Three (3) steps advisers should take to address ESG investing in 2022:

1. **Make simple and clear disclosures regarding your approach to ESG investing.** This should be done in client-facing materials where choices are offered among standardized portfolios focused on ESG issues or customized separately managed accounts designed to accommodate particular client preferences.

2. **Implement policies and procedures that address ESG investing and cover key aspects of your firm's relevant practices.** Detailed, comprehensive investment policies and procedures can result in contemporaneous documentation of ESG factors considered in specific investment decisions.

3. **Make certain compliance personnel are knowledgeable about your firm's specific ESG-related practices.** If compliance personnel are integrated into your firm's ESG-related processes, approaches, and practices, advisers are more likely to avoid materially misleading claims in ESG- related marketing materials and other client-facing documents.

Preparing for 2022: Best Practice for Risk Management

In this evolving regulatory environment, *Risk Alerts* can serve as a valuable tool in informing advisers of focus areas. Another valuable tool is a mock exam. Conducting a mock exam can provide senior management the opportunity to assess the strength and readiness of your firm's compliance program and provide an opportunity to improve policies, procedures, and internal controls that govern business. If you have not had a mock exam over the past three (3) years, consider adding this to the agenda for your compliance program next year. ■